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In the Supreme Court of the United States

OCTOBER TERM, 1959

JOHN T. JARECKI, former Collector of Internal Revenue, ET AL., PETITIONERS

v.

G. D. SEARLE & CO.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

The Solicitor General, on behalf of John T. Jarecki, former Collector of Internal Revenue, and Ernest J. Sauber, former Collector of Internal Revenue and former District Director of Internal Revenue, petitions for a writ of certiorari to review the judgment of the Court of Appeals for the Seventh Circuit in this case.

OPINIONS BELOW

The opinion of the District Court (R. 43-47)[1] is not officially reported. The opinion of the Court of Appeals (Appendix A, *infra*, pp. 8-13) is reported at 274 F. 2d 129.

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[1] Record references are to the Appendix to the brief for the taxpayer in the Court of Appeals.

JURISDICTION

The judgment of the Court of Appeals was entered on January 27, 1960 (Appendix A, *infra*, p. 14). On April 22, 1960, by order of Mr. Justice Clark, the time within which to file a petition for a writ of certiorari was extended to and including June 25, 1960. The jurisdiction of this Court is invoked under 28 U.S.C. 1254.

QUESTION PRESENTED

Whether the income received by the taxpayer from the sale of certain patented drugs resulted from "discovery" within the meaning of Section 456(a)(2)(B) of the Internal Revenue Code of 1939, so as to qualify for the Korean War excess profits tax relief as "abnormal income."

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of the statute and Regulations are set forth in Appendix C, *infra*, pp. 29-32.

STATEMENT

The facts are not in dispute. The taxpayer, which was engaged in manufacturing and marketing ethical drugs, incurred research expenditures prior to 1950, and over a period of more than twelve months, which resulted in the preparation and manufacture of two pharmaceuticals, with the trade names of "Banthine" and "Dramamine". They were not in existence prior to this work and the taxpayer received patents on both. (R. 44; Appendix A, *infra*, p. 9.) During the years here involved, it derived income from sales of these drugs. (R. 44; Appendix A, *infra*, p. 9.)

In this action, the taxpayer sought to recover excess profits taxes aggregating $3,638,238.82 (plus interest) upon the theory that its income from the sales of Banthine and Dramamine constituted "abnormal income" within the meaning of Section 456(a)(2) of the Internal Revenue Code of 1939. (R. 44-45; Appendix A, *infra*, pp. 9-10.) Upon the Government's motion for summary judgment, the District Court dismissed the complaint. It held that the taxpayer's income from sales of Banthine and Dramamine was not income resulting from "exploration, discovery, or prospecting" within the meaning of Section 456(a)(2)(B), but income from the sale of products arising out of research and development and, as such, "specifically prohibited by Congress"—as a departure from a corresponding relief provision as to World War II excess profits taxes, Section 721(a)(2)(C)—from, being considered as income accorded relief under the Korean War law, in Section 456(a)(2).[2] (R. 46-47.)

The Court of Appeals, taking the view that the income in question could qualify for relief as income from "discovery" under Section 456(a)(2)(B), reversed and remanded the case for trial, because in its view a "genuine issue of material fact existed as to whether

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[2] The District Court further held that, as income from the sale of tangible property arising out of research and development, the taxpayer's income from the sale of the drugs in question may not be classified as abnormal under Treasury Regulations 130, Section 40.456-2(b) (as amended by T.D. 6026, 1953-2 Cum. Bull. 235, Appendix C, *infra*, pp. 31-32), promulgated pursuant to the last sentence of Section 456(a)(2). (R. 46-47.) In view of its construction of Section 456(a)(2)(B), the Court of Appeals found it unnecessary to consider this. (Appendix A, *infra*, pp. 12-13.)

Banthine and Dramamine were actually discoveries." (Appendix A, *infra*, p. 13.)[3]

REASONS FOR GRANTING THE WRIT

The sole question presented is one of statutory interpretation. The Court of Appeals for the First Circuit in *Polaroid Corp.* v. *Commissioner* (decided May 3, 1960) (Appendix B, *infra*, pp. 15-28) has expressly disagreed with the Seventh Circuit's decision here. We have been advised that the taxpayer in *Polaroid* will seek review by this Court, and the Government intends not to oppose the petition in that case.

1. The Seventh Circuit interpreted the word "discovery" in Section 456(a)(2)(B) of the Code[4] in accordance with the "common accepted meaning of the word" as set forth in the dictionary, which it regarded as broad enough to include anything which is the result of research and development. (Appendix A,

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[3] Subsequently, on April 22, 1960, the Government filed a motion with the Court of Appeals for leave to file a petition for rehearing, out of time, for the purpose of presenting more extensive legislative history of the Code section here involved and its antecedents, believed to be of controlling significance. That motion was denied, on April 28, 1960.

[4] All Code references herein are to the 1939 Internal Revenue Code.

Section 456 provides that certain amounts of "abnormal income" which really are attributable to other years may (under the formula therein prescribed) be reallocated to such other years so as to afford relief from the burden of the excess profits tax in the year in which they actually are received. In Section 456(a)(2) the term "abnormal income" is restricted to four classes, and the taxpayers in both this case and *Polaroid* assert that their income is within class (B)—

> Income resulting from exploration, discovery, or prospecting, or any combination of the foregoing, extending over a period of more than 12 months * * *.

infra, pp. 11-12.) In direct contrast, the First Circuit in *Polaroid* held that the word "discovery"—because of the context in which it is used in Section 456(a)(2)(B), and in view of the relevant legislative history and related statutory provisions—constitutes a term of art relating only to the mining industries. From the pertinent legislative history, the First Circuit concluded (Appendix B, *infra*, pp. 22-23) that the words "exploration, discovery, or prospecting" had already become "well-recognized words of art", having application only to the mining industries, at the time they were used in the World War II excess profits tax law in Section 721(a)(2)(C) (Appendix C, *infra*, pp. 30-31). There they had been used together with the phrase "research, or development of tangible property", but that phrase was, as the First Circuit pointed out, deliberately omitted from the corresponding provision of the Korean War law, Section 456(a)(2)(B). Further, the First Circuit noted, the pertinent Committee Reports[5] clearly establish that that omission was one of the "changes" intentionally made by Congress in the Korean War law, whereby it "redefined and restricted", in Section 456, "the types of income to which this special treatment [as "abnormal income", to be attributed to other years] was to be afforded." (Appendix B, *infra*, pp. 23-24.)[6]

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[5] H. Rep. No. 3142, 81st Cong., 2d Sess., p. 13 (1951-1 Cum. Bull. 187, 195); S. Rep. No. 2679, 81st Cong., 2d Sess., pp. 13-14 (1951-1 Cum. Bull. 240, 249).

[6] These changes were in keeping with the over-all new and drastically different approach to the granting of relief adopted in the Korean War law—generally discarding the highly discretionary and subjective provisions of the World War II law, and replacing them by provisions for a more objective system, operating automatically

In reaching the "opposite conclusion" from the Seventh Circuit,[7] the First Circuit specifically recognized the absence of any factual distinction between *Polaroid* and the instant case—characterizing this as "a case seemingly on all fours" with *Polaroid* "except that it came up on the granting of the government's motion for summary judgment of dismissal * * *." (Appendix B, *infra*, p. 20, fn. 8.)

2. The question in this case, and in *Polaroid*, presents an important problem in the administration of the relief provisions of the Korean War excess profits tax law—which are just now beginning to reach the appellate level in litigation, and can reasonably be expected to follow in increasing volume in the future.[8] The instant case and *Polaroid* represent the initial litigation concerning the applicability of the relief provisions of Section 456 of the Korean War law to income from sales of products resulting from inventions. By their nature, such controversies generally

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upon prescribed formulas. See H. Rep. No. 3142, 81st Cong., 2d Sess., pp. 16-17 (1951-1 Cum. Bull. 187, 197-198), and S. Rep. No. 2679, 81st Cong., 2d Sess., pp. 17-18 (1951-1 Cum. Bull. 240, 251-252).

[7] With respect to the point concerning the application of Treasury Regulations 130, Section 40.456-2, *supra*, not considered by the Seventh Circuit, the First Circuit held that the Commissioner was not obligated by Section 456 to grant relief on the basis of a classification, outside the statutory classes, suggested by the taxpayer and, further, that the applicable Regulations specifically exclude from the relief provisions income of the type for which the taxpayer in *Polaroid* (as the taxpayer in this case) sought relief. (Appendix B, *infra*, pp. 24-26.)

[8] The Korean War law did not contain any provision like Section 732(c), which made relief questions under the World War II law not reviewable by any court except the Tax Court.

involve very substantial amounts of tax.[9] Resolution of the conflict of decisions would avoid substantial future litigation.

CONCLUSION

Certiorari should be granted.

Respectfully submitted,

J. LEE RANKIN,
Solicitor General.

CHARLES K. RICE,
Assistant Attorney General.

HARRY MARSELLI,
NORMAN H. WOLFE,
Attorneys.

JUNE, 1960.

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[9] This case and *Polaroid* alone involve close to $4,500,000 in taxes.

In addition, as the result of a preliminary search, the Internal Revenue Service informs us that there are pending administratively (or in the Tax Court) at least five other cases, involving approximately six million dollars in taxes.

APPENDIX A

IN THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

SEPTEMBER TERM, 1959—JANUARY SESSION, 1960

No. 12747

G. D. SEARLE & CO., PLAINTIFF-APPELLANT,

v.

JOHN T. JARECKI, former Collector of Internal Revenue, and ERNEST J. SAUBER, former Collector of Internal Revenue and former District Director of Internal Revenue, DEFENDANTS-APPELLEES

Appeal from the United States District Court of the Northern District of Illinois, Eastern Division.

January 27, 1960

Before MAJOR, SCHNACKENBERG and CASTLE, *Circuit Judges.*

CASTLE, *Circuit Judge.* G. D. Searle & Co., plaintiff-appellant, referred to as taxpayer, instituted this action to recover excess profits taxes in the total amount of $3,638,238.82, plus interest, which amount it alleges was erroneously and illegally assessed and collected by the Government for the calendar years 1950, 1951, and 1952. The District Court dismissed the suit on motion for summary judgment filed by the Government. The taxpayer appealed contending the granting of summary judgment was error in that it was based on an erroneous interpretation of the pertinent Internal Revenue Code

provision and that a genuine issue of material fact existed.

The pleadings, a stipulation of facts, and answers to interrogatories and requests for admissions disclose that the taxpayer is engaged in the manufacture and marketing of ethical drugs. Prior to 1950, and over a period of more than twelve months, the taxpayer incurred expenditures which resulted in the preparation and manufacture of two pharmaceuticals with the trade names of Banthine and Dramamine. During the years here involved the taxpayer derived income from sales of these drugs. Both were developed from and arose out of research activities conducted by the taxpayer before 1950. These chemical drug compounds were not in existence prior to their being prepared through experiments with various chemical formulas. The taxpayer applied for and received patents on both products.

The taxpayer claimed that the income from the sales of Banthine and Dramamine constituted abnormal income within the meaning of Sec. 456 (a) (2) of the Internal Revenue Code of 1939 (26 U.S.C. 1952 ed., Sec. 456).[1] Section 456 is designed to afford relief from

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[1] Insofar as pertinent Sec. 456 provides:

§ 456. Abnormalities in income in taxable period—

(a) Definitions.

For the purposes of this section—

(1) Abnormal income.

The term "abnormal income" means income of any class described in paragraph (2) includible in the gross income of the taxpayer for any taxable year under this subchapter if it is abnormal for the taxpayer to derive income of such class, or, if the taxpayer normally derives income of such class but the amount of such income of such class includible in the gross income of the taxable year is in excess of 115 per centum of the average amount of the gross income of the same class for the four previous taxable years, or, if the taxpayer was not in existence for four previous taxable

the impact of excess profits taxes in certain situations which give rise to abnormally high income during the taxable year.

The taxpayer asserted that the income from the drugs Banthine and Dramamine qualified as income resulting from "discovery" within the class of income described in Sec. 456 (a) (2) (B) as:

> "Income resulting from exploration, discovery, or prospecting, or any combination of the foregoing, extending over a period of more than 12 months;"

And, alternatively, the taxpayer asserted that such income is subject to classification as abnormal income pursuant to the Treasury Regulations [2] promulgated under the provision of Sec. 456 that:

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years, the taxable years during which the taxpayer was in existence.

(2) Separate classes of income.

Each of the following subparagraphs shall be held to describe a separate class of income:

(A) Income arising out of a claim, award, judgment, or decree, or interest on any of the foregoing; or

(B) Income resulting from exploration, discovery, or prospecting, or any combination of the foregoing, extending over a period of more than 12 months; or

(C) Income from the sale of patents, formulae, or processes, or any combination of the foregoing, developed over a period of more than 12 months; or

(D) Income includible in gross income for the taxable year rather than for a different taxable year by reason of a change in the taxpayer's method of accounting.

All the income which is classifiable in more than one of such subparagraphs shall be classified under the one which the taxpayer irrevocably elects. The classification of income of any class not described in subparagraphs (A) to (D), inclusive, shall be subject to regulations prescribed by the Secretary.

[2] Treasury Regulations 130, Sec. 40.456-2 (b), as amended by T.D. 6026 (1953-2) Cum. Bull. 235:

(b) Other income, not within a class described in subparagraphs (A)-(D) of section 456 (a) (2), to which section 456 is

"The classification of income of any class not described in subparagraphs (A) to (D), inclusive, shall be subject to regulations prescribed by the Secretary".

The District Court held that the meaning of the word "discovery" as used in the statute, did not encompass the preparation of Banthine and Dramamine because they are products arising out of research and development, and that the Treasury Regulation, to which reference has been made, is not applicable.

The common accepted meaning of the word "discovery" includes "Finding out or ascertaining something proviously unknown or unrecognized; as Curie's *discovery* of radium" (Webster's New International Dictionary (Unabridged 2d ed.) p. 745). We do not deem the maximum *noscitur a sociis* applicable. The wording of subparagraph (B) of the statute indicates that each word should be given significance independently of the others. It refers to "exploration, discovery, or prospecting, or any combination of the foregoing". The context in which the word appears suggests no reason to limit or qualify its commonly accepted meaning.

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applicable, may be grouped by the taxpayer, subject to approval by the Commissioner on the examination of the taxpayer's return, in such classes similar to those specified in subparagraphs (A)-(D) of section 456 (a) (2) as are reasonable in a business of the type which the taxpayer conducts, and as are appropriate in light of the taxpayer's business experience and accounting practice. Income from the sale of tangible property arising out of research and development which extended over a period of more than 12 months is not included in the list of abnormal types of income to which section 456 is applicable, and such income may not constitute a class of income for purposes of that section. However, section 456 is applicable to such income if the income is otherwise properly includible within a class of income to which such section is applicable, for example, the class described in section 456 (a) (2) (D).

That the statute herein involved omitted a provision of a similar World War II Excess Profits Tax Act which in defining abnormal income included that resulting from "research, or development of tangible property" does not in our opinion serve to narrow the scope of the word "discovery" as employed in the Internal Revenue Code provision here under consideration. The elimination of "research" and "development" as factors qualifying income for abnormal income classification served the Congressional objective of plugging "a potential loop-hole of major dimensions".[3] And, absent the element of discovery, income resulting from research or development does not by reason of the latter factors qualify for treatment as abnormal income. But the plugging of the loophole which existed under a former Act because of the use of the unqualified terms "research" and "development" does not require that the word "discovery" which the Congress saw fit to re-employ in the later enactment be regarded as having taken on the limited and qualified meaning the Government would ascribe to it. Neither the context of Sec. 456 nor the legislative history demonstrates that the term "discovery" was intended to describe only the discovery of that which is already in existence, *i.e.*, natural resources. If Congress had intended to limit the meaning of "discovery" it would have been a simple matter for it to have expressly done so.

It is our opinion that income resulting from discovery is not under the terms of subparagraph (B) of the statute precluded from classification as abnormal income merely because research or development may have occasioned, or have been factors which contributed to, the discovery. It is unnecessary to consider the argu-

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[3] H. Rep. No. 3142, 81st Cong., 2d Sess., p. 13 (1951-1 Cum. Bull. 187, 189).

ment advanced by the taxpayer concerning the application of the Treasury Regulation.

We conclude that the District Court erred in its interpretation of the statute and in granting summary judgment for the Government. A genuine issue of material fact existed as to whether Banthine and Dramamine were actually discoveries. Nothing we have said should be regarded as indicating any expression of opinion on the factual issue.

The judgment of the District Court is reversed and the cause remanded for further proceedings not inconsistent with this opinion.

REVERSED AND REMANDED.

A true Copy:
Teste:

____, ____,
Clerk of the United States Court of Appeals for the Seventh Circuit.

UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

Chicago 10, Illinois

Wednesday, January 27, 1960

Before Hon. J. EARL MAJOR, *Circuit Judge;* Hon. ELMER J. SCHNACKENBERG, *Circuit Judge;* Hon. LATHAM CASTLE, *Circuit Judge.*

Appeal from the United States District Court for the Northern District of Illinois, Eastern Division

No. 12747

G. D. SEARLE & CO., PLAINTIFF-APPELLANT,

vs.

JOHN T. JARECKI, Former Collector of Internal Revenue, and ERNEST J. SAUBER, Former Collector of Internal Revenue, etc., DEFENDANTS-APPELLEES

This cause came on to be heard on the transcript of the record from the United States District Court for the Northern District of Illinois, Eastern Division, and was argued by counsel.

On consideration whereof, it is ordered and adjudged by this court that the judgment of the said District Court in this cause appealed from be, and the same is hereby, REVERSED, and that this cause be, and it is hereby REMANDED to the said District Court for further proceedings not inconsistent with the opinion of this Court filed this day.

APPENDIX B

UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

No. 5622

POLAROID CORPORATION, PETITIONER,

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

On Petition for Review of the Decision of the Tax Court of the United States.

Before WOODBURY, *Chief Judge*, and HARTIGAN and ALDRICH, *Circuit Judges*.

OPINION OF THE COURT

May 3, 1960

ALDRICH, *Circuit Judge*. This is a petition by Polaroid Corporation, hereinafter called taxpayer, to review a decision of the Tax Court holding that certain income received during the years 1951, 1952 and 1953 did not constitute "abnormal income" within the meaning of §456(a)(2), Internal Revenue Code of 1939, 64 Stat. 1186 (1951), so as to qualify for the relief provided therein from the Korean War excess profits tax.[1] The taxpayer also contests a ruling that, in computing its net abnormal income for 1951 under §456(a)(3) of the Int. Rev. Code of 1939, the interest with which it was credited in 1951 upon its successful claim for an excess profits tax refund for the years 1942 and 1943 must be reduced by the interest it was charged on income tax deficiencies which resulted from the reduced excess

[1] Excess Profits Tax Act of 1950, 64 Stat. 1137 (1951), which, with later additions, was classified as §§ 430-74, Int. Rev. Code of 1939, and is referred to hereinafter as the KW Act.

profits tax. All facts were stipulated, and the only questions are of law.

Turning to the first issue, it appears that taxpayer was incorporated in 1937. In argument before this court it described itself as "a discovery company," exclusively engaged in exploiting its own discoveries. Edwin H. Land, its President and Director of Research, is internationally known for inventions in the optical and photographic fields, perhaps the most notable of which is the Polaroid Land Camera and film, income from the manufacture and sale of which constitutes the principal matter herein involved.[2] The camera and film together (they cannot be used separately) are termed by taxpayer the Polaroid Land process. This process is unique in that it enables any user to develop his own pictures and obtain positive prints anywhere, sixty seconds after exposure. Taxpayer describes this process as a "revoluitonary discovery." We shall regard that characterization as accurate. Because of numerous patents, taxpayer has no competitors. The result has been a very substantial return of income.

Taxpayer, under Land's direction, started to develop its process in 1944. Much expenditure of time and money was required before its satisfactory achievement in 1947. Unfortunately for taxpayer, large scale production and commercial success coincided with the Korean War years, as a consequence of which income attributable in part to activities in earlier years fell within the provisions of the KW Act. The Act contains several relief provisions. Taxpayer asserts that one in particular is applicable. The Commissioner has disagreed, and the Tax Court has sustained him.

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[2] Also involved is income from sales of taxpayer's synthetic light polarizer for 3-D motion pictures. The parties agree the issues are the same, and that this matter need not be separately considered.

Under the provisions of §456 of the KW Act, income is regarded as "abnormal income," and as such is relieved from the full incidence of the excess profits provisions by reallocation to other tax years, if it falls into certain specified "classes," and meets certain additional requirements which were here concededly met. The principal issue here is whether the income falls within that class described in §456(a)(2)(B): "Income resulting from exploration, discovery, or prospecting, or any combination of the foregoing, extending over a period of more than 12 months; . . . ."[3] Taxpayer asserts that the word "discovery" is broad enough to

[3] The relevant portions of § 456(a) are as follows:

"(a) Definitions. For the purposes of this section—

(1) Abnormal income. The term 'abnormal income' means income of any class described in paragraph (2) . . . if the taxpayer normally derives income of such class but the amount of such income of such class includible in the gross income of the taxable year is in excess of 115 per centum of the average amount of the gross income of the same class for the four previous taxable years. . . .

(2) Separate classes of income. Each of the following subparagraphs shall be held to describe a separate class of income:

(A) Income arising out of a claim, award, judgment, or decree, or interest on any of the foregoing; or

(B) Income resulting from exploration, discovery, or prospecting, or any combination of the foregoing, extending over a period of more than 12 months; or

(C) Income from the sale of patents, formulae, or processes, or any combination of the foregoing, developed over a period of more than 12 months; or

(D) Income includible in gross income for the taxable year rather than for a different taxable year by reason of a change in the taxpayer's method of accounting.

All the income which is classifiable in more than one of such subparagraphs shall be classified under the one which the taxpayer irrevocably elects. The classification of income of any class not described in subparagraphs (A) to (D), inclusive, shall be subject to regulations prescribed by the Secretary."

encompass its process. The government contends that in the context of the Act it relates only to discovery of coal, oil, gas and other natural resources. It bases this in part upon internal evidence, and in part upon legislative history.

Starting with subparagraph (B), standing alone, we note that the word "discovery" admits of so many meanings that some interpretation is called for.[4] The possibility of a number of meanings for one word is a species of ambiguity. We then observe that the word is not isolated, but is sandwiched between the words "exploration" and "prospecting." The government, accordingly, invokes the doctrine of *noscitur a sociis.* In case of ambiguity this is an "appropriate and reasonable," though not always determinative test. *Russell Motor Car Co. v. United States,* 1923, 261 U.S. 514, 519. On a proper occasion "such association justifies, if it does not imperatively require," the application of a restricted meaning. *Neal* v. *Clark,* 1877, 95 U.S. 704, 709. It is particularly appropriate where one meaning of each of the grouped words has a readily apparent common denominator. Thus the words "barrel," "lock" and "stock" have each, individually, a number of quite different meanings. But if used in the phrase, "lock, stock and barrel" there could be little difficulty in determining which particular one of the several meanings was intended. The word "discovery" is clearly identified with the mining industry. See note 4, *supra.* So also are "exploration" and "prospecting." Accordingly we find a consistent, integrated

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[4] According to Webster's New International Dictionary (Second Edition, Unabridged) it includes, "1. . . . . Finding out or ascertaining something previously unknown or unrecognized; . . ." One of these meanings, which we will come to later, is "5. *Mining.* The original finding of part of a vein or lode. It is a prime requisite in the valid location of a mining claim."

unit, each portion of which casts light upon the other.[5]

Taxpayer makes no response to this (other than that set forth in the footnote), except a bare statement that the doctrine of *noscitur a sociis* is inapplicable. Its position is that since the dictionary permits it, "discovery" must be taken to comprehend inventions, or at least major "basic" inventions. If "discovery" is to have that breadth of meaning we could not accept any distinction based upon degrees of invention.[6] While we agree that basic inventions can be described as discoveries, so may any invention, no matter how minor, if it is of sufficient consequence to be entitled to a patent. Cf. United States Constitution, Art. I, §8, Cl. 8; 35 U.S.C. §§100(a), 101. If the word "discovery" is to be

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[5] Taxpayer counters by suggesting that by restricting all three words to mining there would be redundancy. That is not so. "*Discovery*" in this connection has already been defined. See note 4, *supra*. In the Encyclopedia Britannica (11th ed. 1911), in an article on Mining, is found the following: "MINING. . . . The term is not limited to [coal and ore deposits] . . . but includes . . . operations for oil, natural gas or brine. . . . *Prospecting*. . . . The work of prospecting is usually left to adventurous men. . . . The prospector is guided in his search by a knowledge of the geological conditions [etc.]. . . . *Exploratory Work*. . . . Exploratory work is associated intimately both with prospecting and with development, but the purpose is quite distinct from either prospecting, development or working, and it is of importance that this should be clearly recognized. . . ." (We quote the 11th edition of the Encyclopedia both because of its authoritative character, and because it was current when the words "exploration, discovery and prospecting" first appeared in the taxing statutes. See infra.)

[6] It seems peculiarly inappropriate that a person in taxpayer's position should be the one to attempt a distinction between original invention and subsequent minor improvements. Taxpayer possessed over a hundred patents related to the development of its process. How is one to distinguish between that part of income attributable to the original, basic invention, and that attributable to subsequent minor ones? This matter is, in a sense, moot in this case, because the parties have stipulated the amount of the tax. However, the problems it suggests are important.

taken as broad enough to include inventions, we see no reason for including some and excluding others. We are normally reluctant to adopt a construction of a taxing statute which would creat difficult administrative problems.[7] We are entirely unwilling to do so here where the act makes no suggestion of any standard.[8]

However, there is an equally serious difficulty if "discovery" is to include all processes and patented inventions. What, then, is the purpose of subparagraph (C), "Income from the sale of patents, formulae, or processes," of §456(a)(2)? See, *supra*, note 3. True, that subparagraph relates only to income from the *sale* of the patent or process. But subparagraph (B) relates to *all* income. If "discovery" in subparagraph (B) includes inventions, what is the role of subparagraph (C)? If there is a big hole in the fence for the big cat, need there be a small hole for the small one?

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[7] As will be discussed later, certain changes were made in the KW Act over its World War II (WW II) counterpart for the express purpose of avoiding such problems.

[8] In *G. D. Searle & Co.* v. *Jarecki*, 7 Cir., 1960, 274 F.2d 129, a case seemingly on all fours with this one, except that it came up on the granting of the government's motion for summary judgment of dismissal, the taxpayer claimed as abnormal income under the KW Act income from sales of certain ethical drugs. It was agreed that prior to the time taxpayer had developed and patented the formulae such compounds had never been in existence, and that they had had enormous commercial success. The court said, "The common accepted meaning of the word 'discovery' includes 'Finding out or ascertaining something previously unknown or unrecognized; as Curie's *discovery* of radium' (Webster's New International Dictionary (Unabridged 2d ed.) p. 745)." Then, cautioning that it was not "indicating any expression of opinion on the factual issue," it remanded the case to the district court to determine whether these drugs were "actually discoveries" within that definition. In view of the facts already established with relation to these drugs, we are less than clear by what tests the district court is to resolve this question, or how, in general, the Commissioner is to distinguish those patentable inventions which are discoveries from those which are not.

The existence of subparagraph (C) casts further light upon the intended meaning and scope of subparagraph (B). Suppose that instead of manufacturing under its patents, taxpayer had licensed its process to others. Would it be contended that the royalties could be claimed as abnormal income under subparagraph (B), although admittedly, should there be a sale of the process, the proceeds would fall under subparagraph (C)? Rather, it seems more reasonable to hold that Congress, having specifically provided for sales, did not intend by some more general clause to cover income of a similar nature but of less magnitude, i.e., income from a single year's use. There is an even more compelling argument. It is to be noted that §456 does not group together all sources of abnormal income, but is constructed so that the income-percentage requirements must be separately applied as to each classification or group. In determining whether, for example, abnormal income resulting from a judgment (A) is of sufficient size to qualify for relief, it is not possible to take into account abnormal income from prospecting (B). There could be no purpose to this unless each classification or group was intended to have some homogeneity within itself. This is an additional reason for applying the doctrine of *noscitur a sociis* within each group, and at the same time for differentiating one group from another. Taking the statute as a whole, we cannot accept the contention that subparagraph (B) was intended to encompass taxpayer's manufacturing income resulting from its process. On the contrary, we think it clear that "discovery" as used in that subparagraph relates to the mining industries, and to nothing else.

Ordinarily we would stop here, but since the opposite conclusion was reached in *G. D. Searle & Co.* v. *Jarecki*, 7 Cir., 1960, 274 F.2d 129, *supra* n. 8, we will deal briefly

with the legislative history to which the government has devoted its brief. This history falls into two parts; the use since 1918 of the words "exploration," "discovery," and "prospecting" in conjunction, solely with relation to the mining industry, and the particular changes effected by the KW Act over its predecessor, the World War II Act.[9] In Title III, "War-Profits and Excess-Profits Tax," of the Revenue Act of 1918, c. 18, 40 Stat. 1057 (1919), we find a limit placed on the excess profits tax that could be imposed on the proceeds from "a bona fide sale of mines, oil or gas wells, . . . where the principal value of the property has been demonstrated by prospecting or exploration and discovery work done by the taxpayer . . . ." Section 337, 40 Stat. 1096. An identical provision in the income tax portion of the statute, §211(b), 40 Stat. 1064, limited the surtax upon such income in the case of individual taxpayers. Congressional history discloses that these provisions were designed to encourage the search for oil and ore deposits during wartime, and to offset the unfairness of taxing in a single year income which was possibly the result of many unprofitable years of prior search. See S. Rep. No. 617, 65th Cong., 3d Sess. 6 (1918). (1939—1 Cum. Bull. (Part 2) 117, 129-21). They were repeated in the income tax and the excess profits tax titles of the Revenue Act of 1921, c. 136, §§211(b), 337, 42 Stat. 237, 277. There was no further excess profits taxation until 1940, but these words continued to appear in the income tax statutes, with one exception,[10] until excess profits tax imposition returned

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[9] Excess Profits Tax Act of 1940, c. 757, 54 Stat. 975, which, together with later additions and amendments, was classified as §§710-84, Int. Rev. Code of 1939, and is hereinafter referred to as the WW II Act.

[10] The single exception is the Revenue Act of 1934, c. 277, 48 Stat. 680. When the provision was revived in the Revenue Act of 1936,

with World War II. By that time, in the light of this repeated and almost continuous application to the mining industry (and no other), we think that these words had become well-recognized words of art.

The World War II excess profits tax act exhibits a major schematic change from the earlier acts, but again we find the words "exploration," "prospecting," and "discovery" used together in a relief provision. The here relevant portion (noticeably similar, as will be seen, to §456 of the KW Act) was §721(a)(2)(C):[11] "Income resulting from exploration, discovery, prospecting, research, or development of tangible property, patents, formulae, or processes, or any combination of the foregoing, extending over a period of more than 12 months; . . . ." Discussion on the floor of Congress indicates that the mining industry was intended as one of the primary beneficiaries of this relief. See, e.g., 86 Cong. Rec. 12174-77, 12350, 12919 (1940); 87 Cong. Rec. 1636 (1941). With the Korean War enactment, subparagraph (C) of §721(a)(2) was split in two. It is interesting to note the form of this division. The words "exploration, discovery, prospecting" were taken as one group, and placed in subparagraph (B) of the new law, while "patents, formulae, or processes" were placed together in subparagraph (C), and at the same time the words "research, or development of tangible property" were dropped. These changes "re-

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c. 690, § 105, 49 Stat. 1678, the phrase in question was changed to "prospecting or exploration or [instead of "and"] discovery work," and the section as a whole was limited to oil or gas property. In this form it was carried into the Internal Revenue Code of 1939, c. 2, § 105, 53 Stat. 36 (now § 632 of the Int. Rev. Code of 1954).

[11] Excess Profits Tax Act of 1940, c. 757, § 201, 54 Stat. 986, as amended, Excess Profits Tax Amendments of 1941, c. 10, § 5, 55 Stat. 21. Subparagraph (C) of the amended act was derived from, and is practically identical to, subsection (c) of the original § 721.

defined and restricted" the types of income to which this special treatment was to be afforded. H.R. Rep. No. 3142, 81st Cong., 2d Sess. 63 (1950) (1951—1 Cum. Bull. 187, 231). The House and Senate reports described the excised portion as a "potential loophole of major dimensions," and stated that it was being omitted "because there appeared to be no means of restricting such an adjustment to truly meritorious cases other than by the introduction of a large degree of administrative discretion of the type required by the general relief clause of the World War II law (section 722), and because the need for a reallocation of such income seemed to be materially less than in the other classes of income described . . . ." *Id.* at 13 (1951—1 Cum. Bull. at 195); S. Rep. No. 2679, 81st Cong., 2d Sess. 14 (1950) (1951—1 Cum. Bull. 240, 249). Thus even "meritorious cases" that would have come under this now excluded phrase were deliberately sacrificed in the interest of administrative simplification.[12]

In the face of this history, it would be difficult for us to feel that there was introduced into the newly created subparagraph (B) with the word "discovery" a scope of meaning which would include manufacturer's profits from inventions, whether those inventions were revolutionary, or otherwise. Taken in conjunction with internal evidence within the statute itself, we find it impossible.

We turn next to taxpayer's contention, that even if it is not entitled to classify the income in question as "dis-

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[12] In this connection it is to be noted that it was stipulated that taxpayer's income from its process was "income from the sales of tangible property arising out of research and development which extended over a period of more than 12 months." Thus taxpayer must contend that it remained within the purview of this statute after the words which were the most applicable to it were removed.

covery" income under §456(a) (2) (B), it is nonetheless entitled to relief under the last sentence of subsection (a) (2). This reads, "The classification of income of any class not described in subparagraphs (A) to (D), inclusive, shall be subject to regulations prescribed by the Secretary." Note 3, *supra*. The relevant regulations are set forth below.[13] We agree with taxpayer that this sentence may be taken as giving the Secretary the authority to accept classifications outside of the express provisions of subparagraphs (A)-(D). But the language is permissive, and we have found nothing in the historical background indicating that the Secretary's role in agreeing to additional classifications was to be one of obligation rather than of discretion. We therefore reject any contention that the Secretary, or Commissioner, was required to grant relief on the basis of a classification suggested by a taxpayer merely because the taxpayer has income which meets the other tests of abnormality. Nor do the regulations themselves assist the taxpayer. First, any classification by a tax-

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[13] Treas. Regs. 130, § 40.456-2(b) (1951), as amended, T.D. 6026, 1953—2 Cum. Bull. 235: "Other income, not within a class described in subparagraphs (A)-(D) of section 456(a)(2), to which section 456 is applicable may be grouped by the taxpayer, subject to approval by the Commissioner on the examination of the taxpayer's return, in such classes similar to those specified in subparagraphs (A)-(D) of section 456(a)(2) as are reasonable in a business of the type which the taxpayer conducts, and as are appropriate in the light of the taxpayer's business experience and accounting practice. Income from the sale of tangible property arising out of research and development which extended over a period of more than 12 months is not included in the list of abnormal types of income to which section 456 is applicable, and such income may not constitute a class of income for purposes of that section. However, section 456 is applicable to such income if the income is otherwise properly includible within a class of income to which such section is applicable, for example, the class described in section 456(a)(2)(D)."

payer is "subject to approval by the Commissioner," and such approval was not given here. Secondly, under this regulation the classification must be "similar to those specified in subparagraphs (A)-(D) . . . ." If "discovery" relates to mining and natural resources, taxpayer's classification is not "similar." It may be similar (if in fact it is not completely described by the phrase) to "research or development," but the regulations, in accord with the legislative history already discussed, specifically state that income of this class is not subject to relief. The last sentence of the regulations, on which taxpayer places great emphasis, furnishes it no support. That sentence merely provides that income otherwise properly includible within a class is not to be excluded merely because it happens to constitute income from research and development. However, we are unable to find, either in the statute or in the regulations, any class in which to place taxpayer's income other than a classification which is specifically excluded.

One matter remains. Taxpayer, prior to the instant case, pursued a claim for relief under §722 of the WW II Act for overassessments of excess profits taxes for the years 1942 and 1943. In 1951 it was successful. In connection with the settlement it was credited with interest. The government agrees that this interest was abnormal income in 1951. Section 456(a)(2)(A). However, under the WW II Act, the reduction of taxpayer's excess profits income correspondingly increased its normal-tax income, resulting in a deficiency for those years, and an interest charge thereon. The Commissioner held, and was sustained by the Tax Court, that in computing 1951 net abnormal income this interest charge should be subtracted from the abnormal income (i.e., the interest credit) as one of the "costs or deductions relating to such abnormal income, allowable

in determining the normal-tax net income for the taxable year . . . ." [14]

It is true that the interest charge was a result of, and therefore attributable to, the overassessment to which the interest credit was also attributable. Therefore, in a broad sense, they were "related." It is also true that this charge would, in the general compass of the word, constitute a "deduction" "allowable in determining the normal-tax net income." Int. Rev. Code of 1939, §23(b). There is one little cloud. What is the word "costs" doing there? Having in mind the broad meaning that might be given to "deductions" standing alone (as, indeed, including costs), does the presence of the word "costs" suggest that "deductions relating" was intended to mean something relating in the same manner as costs? In H.R. Rep. No. 3142, 81st Cong., 2d Sess. 63 (1951—1 Cum. Bull. 187, 231), it is stated that the clause here in question was intended principally as a "clarification of the technical provisions" of §721 (a) (3) of the WW II Act. Examination of this earlier statute [15] discloses that whatever clarity it may have lacked in other respects, it was entirely clear with re-

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[14] "(3) Net abnormal income. The term 'net abnormal income' means the amount of the abnormal income less, under regulations prescribed by the Secretary, (A) 115 per centum of the average amount of the gross income of the same class determined under paragraph (1), and (B) an amount which bears the same ratio to the amount of any costs or deductions relating to such abnormal income, allowable in determining the normal-tax net income for the taxable year, as the excess of the amount of such abnormal income over 115 per centum of such average amount bears to the amount of such abnormal income." Section 456(a)(3).

[15] The corresponding portion of § 721(a)(3) reads as follows: ". . . direct costs or expenses, deductible in determining the normal-tax net income of the taxable year, through the expenditure of which such abnormal income was in whole or in part derived . . ."

gard to the present question. There the phrase corresponding to "deductions relating" ("to such abnormal income") was "expenses, . . . through the expenditure of which" ("such abnormal income was in whole or in part derived"). This was a limited, causative relationship, entirely compatible with the word "costs," and falling far short of the meaning contended for here by the government. It is true that we are to apply §456(a)(3) and not §721(a)(3). On the other hand, by reading §456(a)(3) in the manner contended by the government we find an awkwardness in, and apparent absence of purpose for, the presence of the word "costs," while we find none if this statute is construed to read like its predecessor. In view of the legislative history, we will adopt that construction.[16]

It may be that from an "equitable" standpoint it would be appropriate for taxpayer's interest out to be offset against its interest in. But as the government was quick to assert when the shoe was on the other foot, we are applying tax statutes, not principles of equity. *See Babcock & Wilcox Co.* v. *Pedrick*, 2 Cir., 1954, 212 F.2d 645, *cert. den.*, 1955, 348 U.S. 936. This ruling of the Tax Court must be set aside.

Judgment will enter vacating the decision of the Tax Court, and remanding the case for further proceedings in accordance with this opinion.

[16] For what it may be worth, we note that the example given by the Regulations (Treas. Regs. 130, § 40.456-1(e) (1951)) with respect to this clause hypothesizes "deductible expenses," not just "deductions."

APPENDIX C

Internal Revenue Code of 1939:

SEC. 456. ABNORMALITIES IN INCOME IN TAXABLE PERIOD.

(a) *Definitions.*—For the purposes of this section—

(1) *Abnormal income.*—The term "abnormal income" means income of any class described in paragraph (2) includible in the gross income of the taxpayer for any taxable year under this subchapter if it is abnormal for the taxpayer to derive income of such class, or, if the taxpayer normally derives income of such class but the amount of such income of such class includible in the gross income of the taxable year is in excess of 115 per centum of the average amount of the gross income of the same class for the four previous taxable years, or, if the taxpayer was not in existence for four previous taxable years, the taxable years during which the taxpayer was in existence.

(2) *Separate classes of income.*—Each of the following subparagraphs shall be held to describe a separate class of income:

(A) Income arising out of a claim, award, judgment, or decree, or interest on any of the foregoing; or

(B) Income resulting from exploration, discovery, or prospecting, or any combination of the foregoing, extending over a period of more than 12 months; or

(C) Income from the sale of patents, formulae, or processes, or any combination of the foregoing, developed over a period of more than 12 months; or

(D) Income includible in gross income for the taxable year rather than for a different taxable year by reason of a change in the taxpayer's method of accounting.

All the income which is classifiable in more than one of such subparagraphs shall be classified under the one which the taxpayer irrevocably elects. The classification of income of any class not described in subparagraphs (A) to (D), inclusive, shall be subject to regulations prescribed by the Secretary.

* * * * *

SEC. 721 [as amended by Section 5 of the Excess Profits Tax Amendments of 1941, c. 10, 55 Stat. 17, and Section 221(a) of the Revenue Act of 1942, c. 619, 56 Stat. 798]. ABNORMALITIES IN INCOME IN TAXABLE PERIOD.

(a) *Definitions.*—For the purposes of this section—

(1) *Abnormal income.*—The term "abnormal income" means income of any class includible in the gross income of the taxpayer for any taxable year under this subchapter if it is abnormal for the taxpayer to derive income of such class, or, if the taxpayer normally derives income of such class but the amount of such income of such class includible in the gross income of the taxable year is in excess of 125 per centum of the average amount of the gross income of the same class for the four previous taxable years, or, if the taxpayer was not in existence for four previous taxable years, the taxable years during which the taxpayer was in existence.

(2) *Separate classes of income.*—Each of the following subparagraphs shall be held to describe a separate class of income:

(A) Income arising out of a claim, award, judgment, or decree, or interest on any of the foregoing; or

(B) Income constituting an amount payable under a contract the performance of which required more than 12 months; or

(C) Income resulting from exploration, discovery, prospecting, research, or development of tangible property, patents, formulae, or processes, or any combination of the foregoing, extending over a period of more than 12 months; or

(D) Income includible in gross income for the taxable year rather than for a different taxable year by reason of a change in the taxpayer's accounting period or method of accounting; or

(E) In the case of a lessor of real property, income included in gross income for the taxable year by reason of the termination of the lease; or

(F) Income consisting of dividends on stock of foreign corporations, except foreign personal holding companies.

All the income which is classifiable in more than one of such subparagraphs shall be classified under the one which the taxpayer irrevocably elects. The classification of income of any class not described in subparagraphs (A) to (F), inclusive, shall be subject to regulations prescribed by the Commissioner with the approval of the Secretary.

* * * * *

Treasury Regulations 130, promulgated under the Internal Revenue Code of 1939:

SEC. 40.456-2 [As amended by T.D. 6026, 1953-2 Cum. Bull. 235]. *Classification of Income.*—

(a) Section 456(a)(2) (A), (B), (C), and (D) sets forth four separate classes of income. All the

income which reasonably is classifiable in more than one class shall be classified under the one which the taxpayer irrevocably elects. Such election shall be made in the manner prescribed in section 40.456-3. The classification of income for any year must be consistent with the classification made under section 456 for previous years. The classification must also be consistent with any classification made in applying section 433(b)(9) to the taxpayer.

(b) Other income, not within a class described in subparagraphs (A)-(D) of section 456(a)(2), to which section 456 is applicable may be grouped by the taxpayer, subject to approval by the Commissioner on the examination of the taxpayer's return, in such classes similar to those specified in subparagraphs (A)-(D) of section 456(a)(2) as are reasonable in a business of the type which the taxpayer conducts, and as are appropriate in the light of the taxpayer's business experience and accounting practice. Income from the sale of tangible property arising out of research and development which extended over a period of more than 12 months is not included in the list of abnormal types of income to which section 456 is applicable, and such income may not constitute a class of income for purposes of that section. However, section 456 is applicable to such income if the income is otherwise properly includible within a class of income to which such section is applicable, for example, the class described in section 456(a)(2)(D).

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